STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Aqua Illinois, Inc.	)	
	)	Docket No. 10-0194
Proposed general increase in water	)	
rates for the Kankakee Division	)	

REPLY BRIEF ON EXCEPTIONS

OF THE PEOPLE OF THE STATE OF ILLINOIS,

BY THE ATTORNEY GENERAL, LISA MADIGAN

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The People of the State of Illinois, by Attorney General Lisa Madigan, (the People) submit the following Reply Brief on Exceptions in response to the Exceptions and Brief on Exceptions filed by Aqua Illinois on November 12, 2010.

I. There Is No Evidentiary Basis For Aqua Illinois's Arguments About The Size or Allocation of Management Fees to Aqua Kankakee and Aqua's Exceptions Should Be Rejected.

Aqua Illinois argues (1) that the Management Fees allocated to Aqua Kankakee are reasonable and (2) that the Company's "proposed allocation methodology is consistent with the methodology that the Commission has approved in prior Aqua rate cases." Aqua BOE at 2. Both of these arguments should be rejected as unsupported by the record or irrelevant.

The question of whether a reasonable level of Management Fees is being charged to Kankakee ratepayers is the ultimate question before the Commission. Aqua asserts that these costs are "subject to review" by Aqua Illinois, and the utility may challenge some costs incurred by its parent. Regardless of whether Aqua has the right or opportunity to challenge the fees which it pays to its parent or affiliated company, it is the Commission's duty to review the total amount Aqua seeks to charge to Aqua Kankakee customers for reasonableness, and Aqua's assertion that they are reasonable does not compel a conclusion that they are.

A. The Figures Aqua Cites From AG Cross Exhibit 6 Support The Proposed Order's Conclusion on Management Fees and Demonstrate That The Kankakee District Is Being Charged Significantly Increased Management Fees When Total Fees Have Either Decreased or Held Steady.

Aqua refers to a decrease in total management fees from 2007 to 2009, citing AG Cross Exhibit 6, to support its argument that these fees are reasonable. Aqua Illinois BOE at 2.

Although it is true that the total management fee for those years decreased,[1] the amount allocated to Kankakee *increased* from $537,319 in 2007 to $618,198 in 2009. AG Cross Exhibit 6, Aqua 001903 and 001905. In the 2011 test year, Aqua claimed a statewide management fee of $1.580 million, compared to $1.504 million in 2007, while the amount allocated to Kankakee jumped from $537,310 in 2007 to $750,969 in the 2011 test year. *Id.* at Aqua 001907. Aqua does not explain why the decrease in total, statewide management fees from 2007 to 2009 is relevant or explain why the amount allocated to Kankakee grew from $537,319 in 2007 to $750,969 in the test year – or 39.76% -- when the total fee is only 5% higher than the 2007 level. Aqua's reference to the 2007 and 2009 total fees does not support its argument that the Management Fees it seeks to charge Kankakee consumers are reasonable.

Aqua also asserts that there is no evidence that the expense is unreasonable. In fact, there is substantial evidence in the record about the level of management fees and their allocation. AG Cross Exhibit 6 contains the data for each year from 2006 through the 2011 test year, and these data show that despite the loss of approximately 11,000 customers, the fees allocated to Illinois have not decreased, and the fees allocated to Kankakee have increased considerably. As the Proposed Order points out, Aqua Illinois and Aqua America will have no incentive to control management fees if those fees can be spread over a smaller and smaller group of customers without regard to whether they have decreased to reflect a smaller customer base.

[1] Aqua Illinois presents the Management Fee amount from the column that excludes "AP Directs" for 2007 and 2009. If the "AP Directs" and "A/C 634" charges are excluded, the amount allocated to Kankakee for 2007 and 2009 were $463,524 and $534m574 respectively. AG Cross Ex. 6. As Mr. Hanley clarified on cross examination, the last column on AG Cross Exhibit 6 should be used to "to compare apples to apples" because Aqua changed its methodology from directly billing some services to a different allocation method in 2010 and 2011. Tr. at 55, lines 10-12. The *total* amount of Management Fees (including both direct and other allocations) was $1.5 million in 2007 and $1.3 million in 2009. The amounts allocated to Kankakee cited in the text above are totals (including AP Directs and A/C 634). Regardless, the amount allocated to Kankakee increased while the total amount of Management Fees decreased.

The People request that the Commission reject Aqua's contention that there is no evidence that the level of management fees is unreasonable. In fact, the record contains ample evidence that the fees have not declined despite a loss of customers, and that Kankakee consumers are being asked to pay a larger portion and a larger amount of those fees as a result of the loss of customers *in other Aqua districts*.[2]

B. Aqua's Testimony In Its Prior Rate Case Refutes Aqua's Claim That The Commission Approved Its Purported Per Customer Management Fees Allocation.

Aqua argues that the Commission approved a methodology for calculating a Management Fee allocation in Aqua's last rate case, and further argues that the Proposed Order's treatment of Management Fees "reflects a fundamental misunderstanding of the allocation methodology, namely, that the number of customers in the Kankakee Division will impact the amount of this per customer charge." Aqua BOE at 3. Aqua provides an elaborate chain of calculations meant to demonstrate how a per-customer allocation works, citing the Order and testimony from ICC Docket 06-0285. *Id*. & 4, fn. 3. Both the assertion that the Commission previously approved the methodology used by Aqua and the description of the allocation calculation are wrong.

Aqua claims that the Commission approved the allocation methodology in Aqua's last rate case, citing Docket 06-0285. Neither the Order in Docket 06-0285 nor the Appendix to the Order mentioned Management Fees or Affiliated Interest expenses. The Order approved a Stipulation between Aqua and the Staff, and that Stipulation presented an agreed revenue requirement. Ill.C.C. Docket 06-0285, Order at 2 (Dec. 20, 2006). Both Aqua and the Staff "reserved the right to litigate in future cases the issues related to revenue requirement and rate design which they resolved via the Stipulation in this case." *Id*. Not only did the Commission

[2] The Proposed Order did increase the allocation to Kankakee to reflect the increase in the number of Kankakee customers, but did not increase it to require Kankakee customers to make up for the loss of customers in other districts. See page 8 below, suggesting that the increased allocation be made explicit in the Order.

not address the allocation or size of Management Fees, but both Aqua and the Staff expressed the intention not to be bound by any resolution of issues in the Stipulation. There is no basis for Aqua's representation that the Commission "has approved" its methodology in Docket 06-0285.[3]

Aqua also cites two pieces of testimony from Docket 06-0285 in support of its statement that the Commission has approved its allocation methodology. Aqua BOE at 3, fn. 3. These documents are not part of the record in this case and Aqua did not ask for administrative notice of these documents under Section 200.640(a)(2) of the Commission's rules. In order to clear up any misimpression that these testimonies in fact presented or accepted the per customer calculation Aqua presents in its BOE, on November 18, 2010 the People filed a request that the Commission take administrative notice of the testimony cited by Aqua in Docket 06-0285: Aqua Exhibit No. 7, filed on August 1, 2006 on E-docket (revised in unrelated respects on August 3, 2006) and Staff Exhibit 8.0, filed on September 6, 2006 E-docket. Both Aqua nor Staff stated that they did not object to the request.

Aqua's testimony in its last Kankakee rate case responded to a Staff adjustment to its "affiliated interest" expense by addressing whether the Company's operations and maintenance expense was reduced "for services provided to Aqua Indiana and Aqua Missouri." Administrative Notice Exhibit 1 at 34-35, excerpt attached to this RBOE. The Aqua witness testified that these expenses were removed from "Total Company Account 675 Miscellaneous Other Expenses." Id. at 36. It is hard to see how testimony about the Miscellaneous Other Expense (which is account number 675) creates precedent for Contractual Services – Management, which is account number 634. Indeed, Aqua witness Hanley testified that there is an affiliated services charge or "corporate charge" in the Miscellaneous Expense account and a

[3] Aqua also cites its witness's testimony and Staff's testimony in Docket 06-0285. These documents are not part of the record in this case and Aqua did not ask for administrative notice of these documents under Section 200.640(a)(2) of the Commission's rules.

separate Management Services charge in Account 634. Tr. at 70, line 1 to 71, line 2.[4] The Docket 06-0285 testimony cited by Aqua in its BOE related to the Miscellaneous corporate expense. In the instant docket there are affiliated corporate charges in the Miscellaneous Expense and affiliated Management Charges in the Contract Services account. See AG Cross Exhibits 5 and 6. Although in the instant case Aqua witness Hanley explained that the 2011 Contract Service account included some charges that formerly were in the Miscellaneous Account, there remain substantial, separate corporate charges in the Miscellaneous Account. AG Cross Ex. 5, Account 675863; Tr. at 72, line 2-11. Although the Miscellaneous Account was the source of the adjustment in Docket 06-0285, in the instant docket the Proposed Order adopted an adjustment to the Contract Services – Management Fee. The Aqua testimony Aqua cited for its exception is in fact inapplicable to the adjustment adopted in the Proposed Order and does not support a change in the Proposed Order.

C. The Chain of Calculations Presented in Aqua's BOE, Which Purportedly Shows How The Management Fees Are Allocated, Is Not Supported By the Record.

In addition to the fact that neither the Commission nor the Staff addressed the allocation of Management Fees in the last Aqua Kankakee rate case, the record in this case does not contain the per customer allocation that Aqua erroneously claims the Commission approved. Aqua presented an elaborate chain of calculations in its BOE to show how the Management Fees are allocated on a per customer basis. Aqua BOE at 3-4. This chain of calculations is nowhere in the record, and in fact, is contradicted by Aqua witness Paul Hanley. Mr. Hanley testified that

[4] The specific question and answer are:
Q. Can you describe the difference between the national management services expense and the Illinois corporate charges?
A. The corporate management fees that we described earlier are allocated to Account 634 to the operating divisions. They don't go through Illinois corporate. Illinois corporate charges are tracked separately in a different accounting unit and then allocated to operating divisions through the 675 account, the miscellaneous expenses. Mr. Hanley testified that the two charges are separate expenses and are not double counting.

prior to 2010, Aqua America directly allocated certain expenses to Kankakee, and those direct allocations are shown on AG Cross Exhibit 6 which shows three categories of direct allocation to Kankakee. From 2006 though 2009, Aqua broke out "AP Directs" as well as "A/C 634" amounts. Mr. Hanley explained that AP Directs could be allocated by customer account or by another method, such as allocating software maintenance based on the number of computers at a certain location. Tr. at 55, lines 1-5. Another portion of this expense is "balance sheet" that represents costs that are not allocated to the states in the same way other expenses are allocated, such as capital costs or rate case expenses. Tr. at 56, lines 5-20; 59, lines 10-21. Aqua's own testimony in this docket shows that not only has the allocation method changed since 2006, but not all expenses are strictly allocated on a per customer basis. There is no basis in the record to accept the chain of calculations Aqua presents in its BOE as the "approved" methodology for the Kankakee Division.

D. The Testimony Aqua Cites From Its Last Rate Case Shows That The Last Allocation To Kankakee Was Substantially Less Than Aqua Seeks In This Docket.

Contrary to the impression left in Aqua's BOE, the testimony that Aqua cited from its last rate case actually supports the Proposed Order's decision to reduce the Contract Management Fees expense because the increased allocation to Kankakee was not justified. Aqua's testimony in its last Kankakee rate case contained an allocation for corporate expenses that was very close to the allocation applied to its 2007 Management Fees. Aqua's testimony in Docket 06-0285 discussed a 35.62% allocation for the 2007 test year, and in this docket Aqua showed a 35.111% allocation for 2007. Compare Administrative Notice Exhibit at 37 and AG Cross Exhibit 5 at page 001903. If there is any precedent at all, it is the use of an allocation factor of approximately 35% for corporate or affiliated management fees.

The Proposed Order addresses Aqua's request to charge Kankakee an increased allocation, and appropriately modified that increase to correspond to the increase in Kankakee customers. The Proposed Order recognizes that there has been an incremental increase in the number of Kankakee customers, and increased the 35% allocation to 40.69% to account for that growth. See Proposed Order, App. at 8. Aqua has not addressed why the Commission should increase the Kankakee allocation beyond the level that accounts for growth in Kankakee, and its exception should be rejected.

PROPOSED LANGUAGE

To clarify that the Proposed Order increased that allocation to Kankakee to account for growth in the number of Kankakee customers, the Order should be modified to include the new allocation. The People recommend the following language at the top of page 13:

> Although the Woodhaven customers represented a significant fraction of Aqua's Illinois customer base, according to the Company, no element of this expense decreased as a result of the loss of customers. In fact, Aqua's Management Fee expense in the test year is substantially higher than it was in the years 2008 through 2010. The Company presumably benefitted from the Woodhaven sale but Aqua Illinois customers did not. It seems reasonable that there should be a decline in at least some elements of management expense due to this substantial loss of customers. We find that allocating parent company expenses within the state on a per customer basis is neither just nor reasonable without recognizing that substantially fewer customers in the state should reduce some Management Fee expense parameters. The number of Kankakee ratepayers increased from 22,400 to 25,975 since the last rate case. We find that the allocation to Kankakee customers of Management Expense fee should reflect the percentage used in the 2007 rate case adjusted to reflect the increase in Kankakee District customers rather than the allocation proposed by Aqua. We therefore find that the allocated amount of Management Fee expense attributable to the Kankakee should be reduced <u>to 40.69% to reflect the growth in the number of Kankakee customers,</u> as reflected in the Approved Operating Income Statement for the Kankakee District incorporated in this Order and in the Appendix attached hereto.

The People also agree with the Staff BOE that the following paragraph on page 13 of the Proposed Order should be deleted. See Staff BOE at 7.

> ~~Staff and the Company have agreed to a 3% annual increase in management expense due to inflation, rather than the 4% increase proposed by Aqua. The AG has argued that the record fails to establish an inflationary trend in prior years that would justify a 3% increase going~~

~~forward. In fact, with the exception of 2009, there is an upward trend in the Kankakee District expense figure. Although we believe that a lower projected rate of inflation would not be inconsistent with the current state of the economy, the evidentiary record does not provide us with a reasonable alternative figure. We therefore find the 3% adjustment to be reasonable and supported by the record. Other than as noted above, we find Staff's adjustments in this category to be proper.~~

II. Conclusion.

The People of the State of Illinois request that the Commission adopt the changes to the Proposed Order described in their Exceptions and Brief on Exceptions and described above.

Respectfully submitted,

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